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ABSTRACT

Student loan alternatives for states, educational institutions, and others who may be facing recent or anticipated reductions in federal aid are considered. Attention is focused on short-run possibilities that require relatively little or no modification of existing federal statutes. Considerations in developing loan alternatives include the following: whether loans will be available and affordable for students who need assistance and no longer have access to Guaranteed Student loans (GSL), the problem of loan default, and whether student borrowers can handle aggregate repayment obligations (federal, state, and institutional). In addition to the traditionally privately financed GSL and the campus-based National Direct Student Loan program, the Parent Loans for Undergraduate Students (PLUS) provides loans to parents at less federal subsidy than GSL. These three federal loan programs, and particularly the new PLUS option, are described, along with state efforts to expand loan availability, financed with tax-exempt bonds or through other means. Attention is also directed to other mechanisms, including corporate support, secondary markets, and savings plans. Rather than depend on federal or state governments, educational institutions can also establish their own loan programs, financed primarily through arrangements with private lenders and possibly supplemented with endowment funds. Appended materials include: information on the levels of assistance available through federal and state programs in the past and as proposed by the Reagan Administration, an outline of the development of federal legislation for student loans over the past quarter century, and estimates of the costs involved in providing loan subsidies and guarantees. (SW)

Financing Student Loans:

The Search for Alternatives
in the Face of
Federal Contraction

Arthur M. Hauptman

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Foreword

This report is intended as a guide for states, educational institutions, and others interested in developing student loan alternatives to help make up for recent or anticipated reductions in federal aid. Some alternatives for providing college student loans already exist, and some are only in the talking stage. The paper speculates on the success of these alternatives, identifies possible pitfalls, and suggests variations that may be helpful.

A May 1981 report from the Washington Office of the College Board, titled *The Guaranteed Student Loan Program: Options for Controlling Federal Costs While Preserving Needed Credit for College*, explored the federal policy dilemma in this area. In the intervening year, the 20-year growth curve of federal student assistance has leveled off sharply, and further cutbacks have been proposed as part of the Reagan Administration's budget for fiscal year 1983.

The array of loan alternatives catalogued in this report is not intended to suggest that "filling the gap" will be easy. Most states and institutions will be hard-pressed to come up with additional resources in the period ahead. Nor do we intend to say that loans are the only way to make up for losses in federal support. Parents no doubt will have to contribute more out of current income and savings; and many students, to the extent they can find jobs, may have to work more. A number of states and institutions are beginning to think about expanded or innovative work-study, cooperative education, and other student employment programs to help fill the gap.

Several further cautions about the scope and purpose of this paper are in order. The study does not systematically probe philosophical issues in the financing of higher education. Who benefits and who pays for college? Who should pay? How should the burden of cost be spread among parents, students, and taxpayers? These fundamental questions bear re-examination in light of changes since 1980; they should and undoubtedly will be the subject of other inquiries.

This report evaluates short-run possibilities, the kinds of options that are being discussed under the immediate pressure of federal retrenchment. Wide-ranging reforms of student loan financing have been suggested and advocated for a number of years, including creation of a national student loan bank and establishment of government-sponsored educational funds from which students could draw advances to be repaid through payroll deductions after the school years. This paper does not consider these more theoretical possibilities for financing college costs. Instead, it focuses on alternatives that require relatively little or no modification of existing federal statutes.

In the face of contraction and uncertainty regarding federal aid policies, it is only prudent that states and institutions begin to design realistic options to assure the availability of student loans. One danger of an increasingly decentralized approach to loan financing, however, is a proliferation of terms and conditions that could become hopelessly confusing to students and parents as well as lenders and aid administrators. Existing loan policies, developed largely within the overall structure of federal legislation, are complicated enough.

A final concern needs to be underscored. In the scramble for alternative funding, the financial needs of students and prospective students at the lower end of the economic scale may be too easily overlooked. Many of the plans and ideas that have surfaced to date tend to be tailored for students and families in the middle- and upper-income ranges or to be designed for the better-endowed institutions. But schemes that address the cash-flow problems of families and institutions do not necessarily strengthen the safety net for those with the greatest need. For this group, existing approaches may have to be modified or new ones developed. This report, in part, is offered as a stimulus.

The "Introduction and Summary" of the report will serve readers looking for an overview of the issues and options in the search for student loan alternatives. The second section describes the federal loan programs with particular emphasis on the new PLUS option. The next section discusses state efforts to expand loan availability, financed with tax-exempt bonds or through other means. Then options open to educational institutions are examined. Finally, some other mechanisms are discussed, including corporate support, secondary markets, and savings plans.

Appendix A shows the levels of assistance available through federal and state programs in the past and as proposed by the Reagan Administration. Appendix B outlines the development of federal legislation for student loans over the past quarter century. Appendix C briefly presents estimates of the costs involved in providing loan subsidies and guarantees.

Arthur M. Hauptman, a consultant to the Washington Office, prepared this report. Robert P. Huff, director of financial aid at Stanford University, encouraged the analysis and offered many constructive suggestions. Paul P. Borden, Stan C. Broadway, Darryl G. Greer, Janet S. Hansen, Robert W. Hartman, Haskell Rhett, and James W. White provided useful comments and corrections on drafts of the report. An ad hoc committee on alternative loan approaches, comprised of state officials and chaired by Joseph M. Cronin, also offered valuable insights. William Ferris edited the manuscript. Diane C. Erving, Valerie Bullock, and Irene Wu typed and proofed the drafts.

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Lawrence E. Gladieux, *executive director*

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Financing Student Loans:

**The Search for Alternatives
in the Face of
Federal Contraction**

Introduction and Summary

Following several years of rapid expansion, recent and proposed cutbacks in the Guaranteed Student Loan (GSL) program have alarmed students, their families, and colleges. GSL in academic year 1981-82 paid for about one-fifth of all college-going costs, and 3 out of every 10 students borrowed under the program. Large-scale reductions in loan availability could thus greatly complicate the financing of postsecondary education. Moreover, GSL reductions have been accompanied by retrenchment in other federal student assistance programs, including a phase-out of Social Security benefits for postsecondary students.

The Reagan Administration's fiscal 1983 budget proposes further restricting GSL; it would also slice appropriations for Pell Grants nearly in half and eliminate new funding for most other federal programs for college students. If fully adopted, the Administration's proposals could reduce aid available through federal programs by 40 to 50 percent in the course of a few years, thereby bringing federal aid down to about the same level that existed before the Middle Income Student Assistance Act of 1978.

These cutbacks in assistance have implications for a broad range of students. The 1981 GSL changes were focused primarily on restricting eligibility for higher-income families, although the new origination fee is imposed on GSL borrowers from all income levels. Future changes in GSL are likely to touch all borrowers but may focus especially on students who are now judged under federal criteria to be financially independent of their parents. Reduced Social Security benefits will primarily affect students from low- and moderate-income families. Changes in Pell Grants would result in smaller grants for low-income students and would end eligibility for most middle-income families.

Congress will no doubt stop far short of adopting the entire package of student aid proposals presented by the Administration. The most extreme cutbacks in GSL will be rejected, and appropriations for other programs will likely be substantially higher than proposed levels. Nonetheless, the Administration over the next several years can be expected to keep pressing for reductions in student aid, both as a matter of philosophy about the government's obligations to students and as part of its general commitment to trim expenditures for domestic programs.

In short, overall budget pressures will doubtlessly hold down federal assistance to students in postsecondary education over the next few years. Perhaps the best that can be expected is level funding. But with college tuitions and general inflation continuing to rise, holding the line on student aid may mean substantial reductions in the ability of students to pay their costs of attendance.

In the face of federal contraction, the search has begun across the country for alternative ways to help students pay for college. Expansion of loan opportunities appears to be a popular option. Loans have the attractive feature of being less costly than grants because they are repayable, generally with interest. Even in the expensive GSL program, the long-term federal costs are about half the amount required to provide a similar number of grants. Because of this cost-effectiveness feature, loans can reach more students than grants. Moreover, many believe that

The Demand for Alternative Loan Programs

loans—through the repayment process—make students more directly aware of the value of their education.

States, educational institutions, private lenders, investment bankers, and others are all engaged in an effort to provide loans that would help fill the gap created by cutbacks in federal student aid. Loans for college, in this context, represent one laboratory for testing the Reagan hypothesis that states and nonprofit organizations, in collaboration with the private sector, are capable of taking over responsibilities previously assumed by the federal government.

A decade ago, it was not clear whether students and their families would be willing to borrow in large numbers and in large amounts to pay for the rising costs of college. The GSL experience of the past several years strongly suggests that students and families faced with mounting college costs are more than willing to borrow when loan terms are considerably better than those in the open market.

When loan terms are less favorable, however, demand for loans will vary. Students from middle- and higher-income families who lose their GSL eligibility and whose income and savings are not sufficient to meet college costs, especially at higher-priced private institutions, may be ready to borrow in new nonfederal programs even at terms substantially less attractive than GSL. If new loan sources are not sufficient, many of these families may have to send their children to lower-priced institutions. Lower-income families, with deep-seated fears about excessive repayment burdens, can be expected to be less active borrowers even as their other assistance dwindles. In short, new loan programs are not the solution for everybody.

A rough calculation suggests that to make up for already enacted cutbacks in GSL and other student aid, new loan options (federal or nonfederal) would have to provide, at a minimum, \$1 billion. With further reductions in federal aid, demand for loans will likely rise. To the extent that terms in alternative loan programs can be made more attractive than what the private market can offer, demand will increase and could easily grow to \$2 billion or more if student aid cutbacks are severe.

Can New Programs Fill the Gap?

An initial assessment of the potential for filling the gap created by federal cutbacks cannot be optimistic. Most states are engaged in their own budget battles. With the exception of Alaska, Texas, and a few other states favored by demand for their natural resources, state revenues are hardly booming. Thus prospects for increased state funding of student loans seem not very bright. Moreover, new state loan assistance would probably have to come from funds that otherwise would be used for grants, fellowships, and general payments to institutions, a tradeoff that many in the higher education community would prefer not to make.

The endowments of educational institutions hold limited potential for generating student loans. The current value of endowments is between \$10 billion and \$15 billion and the income from these funds is perhaps \$1 billion to \$2 billion. But most of this income, and the assets from which it is derived, is either explicitly

committed to other uses or is needed to meet operating costs. Furthermore, endowments sizable enough to make a dent in student loan needs are concentrated in relatively few institutions, thereby excluding this option for the majority of students in postsecondary education.

Private capital, of course, can be tapped for student loans. But the private sector, to part with its funds, needs assurances of a sufficient yield and good security. Providing such assurances may result in terms that most student borrowers could not afford. In short, even though private capital is potentially available, students will not borrow if the cost is too high.

The alternatives discussed in this paper share one characteristic: they all rely primarily on the private sector as a source of funds. The premise here is that states and schools do not have the financial resources to provide sufficient loan capital. There is also the presumption that the major role for government (state or federal) and for educational institutions is to make loan terms more attractive than private market conditions through the provision of tax breaks, interest subsidies, or loan guarantees.

For states, schools, or others interested in enhancing the terms of private sector loans for borrowers, a question may arise as to whether interest subsidies or loan guarantees are the better way to make sure that loans are available at affordable prices. In general, it appears that loan guarantees or reserves against default are cheaper to provide than interest subsidies. Certainly this is borne out by the GSL experience where, despite relatively high default rates, guarantee costs account for only 10 percent of total federal GSL expenditures. For new loan programs, the long-term costs of insuring against the risk of default are substantially lower than what would be required to pay the in-school interest payments or to subsidize or "buy down" interest rates throughout the life of the loan. On the other hand, subsidizing interest rates normally will permit more affordable loan terms than simply the provision of a guarantee against default.

The merits and potential of a student loan alternative will depend on how it responds to a number of conditions. For example:

Will loans be available for students who need assistance and no longer have access to GSL? To insure loan availability, a variety of capital sources should be explored including state appropriations, endowment funds, banks, tax-exempt bonds, and other possibilities such as corporations, foundations, and pension funds. Planners must be realistic in evaluating the potential of each source. Alternatives may be found wanting if they apply only to limited sectors of postsecondary education or if they fail to serve students from a broad spectrum of society.

Will loan terms be affordable for students and their families who desire to borrow? Many students and their parents will be excluded from alternative loan programs if interest rates are set at market levels or if repayment is scheduled to begin while the student is still in school. Ways to reduce costs to borrowers below market include the use of tax-exempt bonds (with their lower interest) as a source

Considerations in Developing Loan Alternatives

of capital; provision of loan guarantees or reserves against default to reduce risk to private lenders; and interest subsidies provided by states, schools, or other organizations.

Are loan servicing and collection procedures adequate to prevent the possibility of widespread default? Because no collateral is generally required for student loans, and because borrowers are often unfamiliar with loan repayment procedures and requirements, defaults have been a persistent problem. Remedial steps have helped to moderate GSL defaults, but default rates in the program still exceed those for consumer-type loans (where credit checks and collateral are generally required). Defaults in NDSL remain a great source of concern, and consequently any loan alternative that relies on educational institutions to collect on loans to former students may encounter resistance.

Does the creation of multiple loan programs—federal, state, and institutional—lead to the possibility of an excessive repayment burden? A recurring concern in debates over student loans is whether student borrowers will be able to manage their repayment obligations. The recent focus on cutbacks in the federal program has shifted attention from worries about too much loan money being available to the possibility of too little. But if new loan programs proliferate, the spectre of different loan programs stacked upon each other may lead to renewed discussion of whether student borrowers can handle their aggregate repayment obligations.

Will a multiplicity of student loan programs cause confusion for both borrowers and lenders? One great advantage of GSL has been the standardization of loan paper. If, instead, there had been no GSL program and states had proceeded to establish their own programs in the late 1960s and 1970s, the diversity of loan paper would have greatly retarded the growth of a secondary market for student loans, a crucial element that has fostered the recent expansion of GSL. A proliferation of loan programs may saddle borrowers with repayment obligations that vary in interest rate, length of repayment, and the like. If many new student loan programs are created, these concerns about divergent types of student loan paper need to be addressed.

Working with the Federal Programs

While federal student loans are now likely to decline after two decades of growth, the federal role in student loans will continue to be substantial. In addition to the traditional privately financed GSL and the campus-based National Direct Student Loan program (NDSL), the Congress in 1980 authorized Parent Loans for Undergraduate Students (PLUS)—a program to provide loans to parents at less federal subsidy than GSL. In 1981, interest rates for PLUS were raised above those charged for GSL while eligibility was extended to certain groups of students.¹

1. The 1981 legislation created the term Auxiliary Loans to Aid Students (ALAS) to refer to this new type of federal student loan, but the Department of Education has opted instead to use PLUS to designate less subsidized federal loans for both parents and students.

PLUS enables parents to borrow to help stretch out the financial obligations of paying their children's college costs. It seems likely that the program, which compares favorably to private loan terms, will eventually grow to become an important source of aid for parents.

PLUS for students, on the other hand, appears unlikely to blossom in its present form. Higher interest rates than GSL and no in-school interest subsidy will add significantly to the repayment burden for student borrowers both while still enrolled and after repayment of principal begins. Lenders, too, appear uncomfortable with the immediate payment schedule that PLUS requires of student borrowers.

Existing legislation should be modified to provide a workable, less subsidized federal loan program for students unable to borrow under GSL. Such a program should probably entail a guarantee against default, an interest rate lower than that charged to parents under PLUS, and flexibility in the way that students are able to meet their in-school interest obligations. If student eligibility for the regular GSL is further limited, efforts should be intensified to make sure that an alternative federal program is in place. Federal loan terms are likely to be more attractive to borrowers than nonfederal terms. Moreover, one alternative federal program will do more to establish a fluid, operational secondary market than a large number of institutional and state programs, each offering different terms and repayment schedules. Without some legislative change, however, federal student loans less subsidized than GSL are likely to remain dormant and increase the pressure on states, educational institutions, and others to create nonfederal alternatives.

The nonfederal loan alternative that has gained the most attention so far is legislation in Illinois establishing a new state agency to issue tax-exempt bonds. The essence of the Illinois plan is to use tax-exempt financing in order to lower the interest rates charged to borrowers, and to require participating educational institutions to provide reserves against default, thereby absolving the state of any financial commitment. Massachusetts, Iowa, and Rhode Island have passed legislation similar to the Illinois plan; several other states are about to follow suit.

But there are many reasons to believe that the Illinois-type plan will not generate a large volume of student loans. The tax-exempt bond market is already strained; many recent issues have not been fully subscribed. Moreover, the Reagan Administration's proposals to restrict the use of tax-exempt financing for private purposes such as the construction of shopping centers may affect the student loan market as well. Establishing a new agency can be a time-consuming process, and attaining a satisfactory bond rating will no doubt extend the time required to make loans available to students. It also appears that relatively few educational institutions have sufficient collateral to insure against borrower default, thereby restricting loan availability to a limited number of schools or students.

While the underlying problems of using tax-exempt financing cannot be averted, some of the drawbacks of the Illinois legislation can be addressed through

State Role

modifications in the plan. Simply extending the charter of agencies already borrowing in the tax-exempt market—rather than creating a new borrowing authority—would greatly reduce the start-up time necessary to make loans available. Further, a modest state commitment to guarantee loans against default would extend borrowing to a much wider range of students by not restricting availability of funds to schools with large endowments.

States may discover that their most influential role is in promoting the federal loan programs—GSL and PLUS. State guaranty agencies in Massachusetts and New Jersey can justly take credit for the growth of PLUS in their states through active and enthusiastic promotion with their lenders. States could initiate or expand their own direct lending under GSL or PLUS to compensate for private lender reluctance, although weakness in the tax-exempt bond markets limits the potential of this approach. States could also choose to subsidize borrowing terms in the federal programs by, for example, reducing interest rates charged to borrowers, but with tight budgets in most states, interest subsidies might dig too deeply into grants for needy students.

Options for Schools

Educational institutions concerned about more restrictive federal policies and not willing to wait for state action can take steps on their own to help insure the availability of loans to their students. Under the federal programs, schools can become direct lenders, although, for most, the financial and administrative commitment of direct lending may be prohibitive. Instead of or in addition to direct lending, educational institutions could choose to subsidize GSL or PLUS borrowing terms, thereby substituting their own funds for what was formerly provided by the federal government. As already noted, however, interest subsidies can be an expensive proposition, and there may not be many institutions with the financial resources at their disposal to undertake such a role.

Rather than depend on federal or state governments, educational institutions can also establish their own loan programs, financed primarily through arrangements with private lenders and possibly supplemented with endowment funds. This type of approach holds some promise: the start-up time is minimal and loan terms can be tailored to the specific needs of students at a particular institution. Under a private lending arrangement, schools could use their own limited funds to subsidize loan terms or to contribute to reserves against default, thereby making loans more available and affordable for their students. The major obstacle to the independent loan approach is the difficulty of establishing a secondary market for loans that differ considerably in interest rate, repayment terms, and other characteristics.

Other Possibilities

New student loan initiatives are not restricted to the states or the campuses. Corporations, for example, could seek to assure loans for their employees and families and possibly even subsidize loan terms as part of the company benefit package. To entice new employees, a company could offer to pay a portion of the

individual's previously incurred monthly repayments, an idea which Beloit College calls the "cancellable loan" option.

The existence of a viable secondary market is crucial to assuring sufficient loan availability as private lenders, to cope with economic uncertainties, need an outlet for their student loan paper. The Student Loan Marketing Association (Sallie Mae), a government-created private corporation, in its role as the largest secondary market for student loans, performs a number of important functions including buying student loan paper, lending funds to banks and others using student loan paper as collateral (a process called "warehousing"), and making commitments to purchase or refinance the tax-exempt bonds of state agencies. The 1980 and 1981 federal legislation greatly expanded Sallie Mae's potential role in student loans, including, for the first time, nonfederal loans.

Recently, states, banks, and others have begun to establish secondary market operations of their own, in part to fill perceived gaps in Sallie Mae's services. New sources of funds for secondary markets should be encouraged. For example, the rate of return on pension funds might be increased—at no additional risk—by using these funds as a "warehouse" for federal loans. Or for educational institutions that have set up their own loan programs, foundations might offer financing to provide funding until borrower repayment of principal begins.

Finally, additional financing for college costs can be encouraged through tax incentives for family saving. Some incentive exists in the current tax system for families to save for college costs—for example, through custodial trusts—but only higher income families can generally benefit from these tax advantages. Legislation could be enacted to allow tax-sheltered saving for educational purposes, just as now exists for retirement. Such an approach might well gain more support than is being accorded the more traditional idea of tax credits for current educational expenses.

Even without new tax advantages, provision can be made to link family savings plans with loans for college. An Atlanta firm, for example, is prepared to offer loans several times larger than the amount of funds parents maintain in a savings account at a participating bank. With the savings account used as collateral and as a low-cost source of funds, interest rates charged for the loans can be set substantially lower than market.

"Filling the gap" in student aid over the coming years will not be easy. Many of the alternatives discussed in this paper are not necessarily feasible or suitable for different states, schools, or others interested in making sure that loans are available to offset enacted and proposed reductions in federal aid for students. Alternative programs must be developed in light of the needs of the students they are intended to serve and the financial resources necessary to provide loan capital, guarantees, and subsidies. Given the time it takes to develop and implement new loan programs, steps should be taken now to design realistic options.

The Need To Get Started

The Federal Loan Programs

Traditionally the two principal federally sponsored loan programs for students attending postsecondary education have been National Direct Student Loans (NDSL) and Guaranteed Student Loans (GSL).¹

NDSL

NDSL was created in 1958 as part of the National Defense Education program in response to Soviet space achievements. Direct federal appropriations provide 90 percent of the capital for these low-interest (initially 3 percent, now 5 percent) loans to needy students. Educational institutions are responsible for selecting borrowers from an eligible pool as well as loan servicing and collection. Repayments are channeled into a revolving fund at the institution and used for new loans. Currently, about half of annual new lending volume in NDSL is financed through repayments of loans made in previous years.

Several million students over the years have financed part of their college costs through NDSL; in the 1960s it was a primary source of student assistance. But in the 1970s, federal funding for NDSL hit a plateau, in part because new capital contributions appear as a direct item of federal spending. High default or delinquency rates and low interest rates have helped to make NDSL a target for federal budget cutters. In any case, NDSL now finances a small share (about 2 percent) of the costs of attending postsecondary education, and future funding for NDSL is not likely to increase.

GSL

While NDSL declined in importance during the 1970s, GSL grew in stature. From the initial GSL legislation through subsequent amendments, borrowers and lenders have found GSL a worthwhile investment. Lenders are fully guaranteed against loss because of default, and their rate of return is tied directly to fluctuations in general interest rates. Borrowers pay no interest while in school and for a short period thereafter, and once repayment begins, interest rates are decidedly below market (7 percent for old borrowers, 9 percent for those who first borrowed after January 1, 1981).

In establishing GSL in 1965, the federal government sought to achieve several goals not met by existing student loan efforts. A major thrust of the program was to make loans available to students previously excluded or inhibited from borrowing because of their state of residence or their choice of institution. While NDSL was increasingly targeted on lower-income students, GSL was for students from a broader spectrum of family incomes. In addition, loan limits for NDSL and other existing programs were inadequate to meet the costs of higher-priced institutions or postbaccalaureate study.

During its first decade, GSL exhibited steady if unspectacular growth interrupted only by a slump in 1973-1974 caused by confusion over proposed rule

1. A number of other federal loan efforts have been authorized over the years for designated groups of students such as health professionals or Cuban refugees. But these programs are relatively small and serve a limited clientele.

changes that were later scrapped. By 1976, annual loan volume had risen to about \$1.5 billion, certainly an important source of aid but not strategic in the overall financing scheme for postsecondary education.

In every year since 1976 there have been major changes in the Guaranteed Student Loan (GSL) program. Annual modifications in the late 1970s were aimed at expanding student eligibility for loans and ensuring that supply was sufficient to meet rising demand. In 1980, the legislative direction began to shift from expansion toward contraction to stem the rapid growth in GSL costs and as part of a broader effort to reduce the federal deficit.

The Growth of GSL

In the fiscal years 1979 through 1981, there was a GSL explosion. Approximately \$16 billion were lent, more than the cumulative total for the preceding thirteen years. During the years of growth, GSL became a major source of assistance for students and the institutions they attended. In the academic year 1981-82, tuition, fees, room and board, and other necessary expenses of postsecondary education nationwide cost approximately \$40 billion. About \$8 billion in GSL was used to finance those costs—20 percent of the total bill. In 1975, about 1 in 10 students was a GSL borrower. By 1981, that figure had grown to over 3 in 10. At many institutions including a number of prestigious colleges and universities, more than half of the student population now borrows through GSL.

The increased loan volume combined with unprecedented interest rates has led to an extraordinary jump in federal payments to lenders. In fiscal year 1981, total federal obligations for GSL approached \$3 billion, compared to \$500 million in 1975 and \$1 billion in 1979. For the most part, these costs are a necessary consequence of making loan terms affordable to student borrowers while keeping the rate of return sufficiently attractive and secure for lenders to continue their participation in the program. In fact, about half of the federal cost increase for GSL in recent years is directly attributable to the escalation in general interest rates.

Most observers would agree, however, that some reform in GSL has been necessary. In the past several years of high interest rates, more students and their families have begun to realize the potential for borrowing at low interest (interest-free while in school) and investing at higher rates those funds that otherwise would be used to pay college-related costs. There is also reason to believe that GSL may have been more attractive to the lending community than necessary as the program has grown rapidly in the face of extremely tight overall credit conditions.

Scaling Down

Legislative steps were taken in 1980 and 1981 to bring down spiraling GSL costs by tightening eligibility and raising costs to borrowers. The interest rate charged to new GSL borrowers was raised from 7 to 9 percent. A 5 percent origination fee is now deducted from the face value of all new GSLs, with the fee

revenues used to offset federal costs. Students with family income over \$30,000 must meet a needs test, thereby preventing higher income parents from substituting GSL for what they are expected to contribute to their children's educational costs.

Changes proposed by the Reagan Administration in 1982 would extend the needs test requirement to all GSL borrowers regardless of their family income. It would double the origination fee from 5 to 10 percent and would require borrowers to pay market rates of interest two years after they begin loan repayment. It would be particularly harsh on graduate and professional students—one-quarter of the GSL borrowing population—by totally eliminating their GSL eligibility.

The concern is that changes in GSL will reach beyond unnecessary or "frivolous" borrowing and will affect more than just those borrowers who have unfairly benefited from liberal eligibility rules and favorable loan terms. Recent changes—by raising costs to all borrowers, by increasing paperwork requirements, and by restricting eligibility—could eliminate or limit loan availability for thousands of students who legitimately need these funds to attend the institution of their choice or to continue their education at all. A greater fear is that additional changes will cut off loans for many more students by further restricting access and raising borrower costs in GSL.

How Many Students Will Be Affected?

Because of unreliable GSL program data and uncertainty about the behavior patterns of borrowers and lenders, it is difficult to estimate precisely how legislative changes will impinge on GSL borrowing. For example, solid information is not available on how many borrowers have family incomes above \$30,000 or the proportion attending higher-priced institutions. Nor is it clear how borrowers will react to higher interest rates or to what extent banks will reduce their GSL participation because of additional paperwork requirements or smaller average loans resulting from imposition of the needs test.

Under the old program rules GSL loan volume in fiscal year 1982 would have reached \$9 billion, based on recent trends and anticipated inflation increases. Instead, as a result of the 1981 budget reconciliation changes, GSL loan volume in 1982 is predicted to drop below \$7 billion. Full adoption of the Reagan Administration's new budget proposals would probably reduce GSL volume to less than \$5 billion, or about half of what would have been available under policies in effect before 1981. These cuts translate into more than 1 million borrowers whose college going plans may be affected in some way by changes in the GSL program. The Administration assumes that the new PLUS loan program (discussed in the following section of this report) will be able to pick up the slack created by restrictions on GSL. But in light of the PLUS experience thus far, the Administration's projections appear unrealistic.

For over a decade suggestions have been made that the federal government should sponsor a program to provide loans to parents whose liquid assets are insufficient to meet the staggering cost of college. In the past, there have been limited ways for parents to borrow in order to stretch out their financial responsibilities. As one example, the Knight Insurance Company of Boston offers a private loan plan for parents, although it is only available for students attending a few dozen institutions. Parents can also get a consumer-type loan from their local bank, but collateral requirements and high interest rates discourage this form of financing. Some parents have also used the low-interest loan provisions in their insurance policies to pay for college costs.

PLUS

Far away from the central legislative focus of the Education Amendments of 1980, Congress authorized PLUS to help families with the cash-flow problems created by the rising costs of college. Like GSL, PLUS loans are privately financed and guaranteed by state agencies and reinsured by the federal government against death, disability, default, or bankruptcy of the borrower—in this case, the parent. Also copied from GSL was provision of a federal special allowance payment to assure lenders a competitive yield on their investment. Parents can borrow up to \$3,000 per year in PLUS compared to the \$2,500 annual limit in GSL for undergraduates and the \$5,000 GSL maximum for graduate and professional students.

Unlike GSL, there is no federal payment of in-school interest obligations under PLUS. Repayment of both principal and interest begins within sixty days of when the loan is disbursed. Initially, in 1980, the interest rate for PLUS was set at the same level as that charged to new GSL borrowers—9 percent. But in 1981, as part of the budget reconciliation legislation, the interest for PLUS was raised to 14 percent in order to reduce the incentive for parents to borrow at below market rates.²

Also in 1981, eligibility to borrow in the PLUS program was extended to students in graduate or professional school programs and to undergraduates who are financially independent of their parents.³ The PLUS terms for students are the same as those for parents except that full-time students may defer the repayment of principal until they leave school.

Thus far, PLUS loan volume has been limited for several reasons. Most states, in order to participate, must pass legislation to extend the charter of their guaranty

2. The legislation calls for the PLUS interest rate to drop to 12 percent whenever Treasury rates for a full year fall below 12 percent.

3. As noted earlier, the 1981 legislation coined the term ALAS—Auxiliary Loans to Aid Students—to refer to federal loans that do not carry the in-school interest subsidy. The Education Department has decided, however, that the best way to avoid confusion is to use the PLUS label for both parents and students (and to drop the somewhat unfortunate acronym of ALAS).

agencies to accommodate the fact that the borrowing population and loan terms are different from those of GSL. Many lenders and private servicing agencies do **not** appear ready for or favorably disposed toward the immediate repayment schedule required under PLUS. A ready secondary market does not yet exist for PLUS. And since most of the new restrictions on GSL did not go into effect until October 1, 1981, there was little incentive to shift to PLUS in fiscal 1981. For whatever reason, PLUS volume in fiscal year 1981 reached only \$25 million, distributed to about 10,000 borrowers. This amount was well below the earlier estimates of the Reagan Administration. Moreover, three-quarters of the loans were guaranteed by just two state agencies, Massachusetts and New Jersey.

The experience of these two states in providing parent loans is instructive. In both, a large local savings bank facing a dried-up mortgage market decided to take a plunge in parent loans. Use of a flagship lending institution to stimulate parent loan activity was apparently a crucial element of success in both states. In addition, the guaranty agencies within their respective states actively promoted the concept of PLUS with lenders, borrowers, and educational institutions.

While the primary congressional intent in authorizing PLUS was to expand borrowing options, it has become apparent that the Administration views PLUS as an essential piece in its strategy for reducing federal costs for college loans. PLUS is less subsidized than GSL, and the Administration seems intent on shifting as much borrowing as possible from GSL to PLUS. In the hope that prediction will help to shape reality, the Administration continues to produce highly optimistic projections of PLUS volume. The President's budget for fiscal 1983 estimates that PLUS will grow to about \$4 billion. In light of experience to date, the Administration's figures can best be described as wishful thinking.

Nonetheless, PLUS is likely to grow. By the end of 1982, virtually every state is expected to be ready to guarantee PLUS loans. For those states unable or unwilling to perform the guaranty function, the Education Department is prepared to approve alternative arrangements. And as it becomes clear that certain families are no longer eligible for GSL, a growing number of borrowers—parents and students—will no doubt look more favorably toward PLUS as the way to help their children and themselves finance the cost of college.

PLUS for parents will most likely become a significant source of loan aid. The terms are competitive with what banks can offer in a consumer-type loan, and provision of a federal guarantee and special allowance payments should induce lenders to participate. Future growth of PLUS for parents depends now on the rate at which states actively establish PLUS arrangements with their lenders.

The future of PLUS for students seems much less bright. Lenders appear uncomfortable with the immediate repayment of interest while the borrower is still in school. For student borrowers, PLUS is more burdensome than GSL in two important ways. The interest is 14 percent rather than 9, *and* it must be paid during the in-school period. A student's yearly repayment for a \$3000 PLUS loan would be approximately \$1,050. This amount is \$450, or 75 percent, more than the

annual repayment for a GSL of the same size.⁴ This "double-whammy" of higher interest and no in-school interest subsidy represents a substantial obstacle to extensive use of PLUS for students.

Because of these concerns, PLUS for students is likely to wither without further legislative modification. One possible remedy is to reintroduce the pre-1978 GSL option in which students above the family income ceiling could borrow in GSL but would not be eligible for the federal in-school interest subsidy. This provision was, in effect, wiped off the books in 1978 when eligibility for the in-school subsidy was extended to all students regardless of family income. However, it was not reinstated in 1981, when a needs test requirement was imposed for students with more than \$30,000 in family income.⁵

Loans without the in-school interest subsidy represented less than 5 percent of the pre-1978 GSL loan volume as banks balked at the cumbersome billing procedures that these loans required. This constraint on lending activity could be reduced if a variety of alternative repayment procedures were explored such as allowing interest to be deferred and accrued to principal or permitting estimated in-school interest obligations to be discounted from the loan disbursement.

For students ineligible for the regular GSL program, a less subsidized GSL would still be far preferable to PLUS terms or to those that are likely to be offered in many private loan alternatives. Moreover, individual students would face one interest rate for federally guaranteed loans regardless of whether they qualified for the in-school subsidy—a vast improvement on the current confusion of different federal rates for the same borrower.

4. To provide a fair comparison of repayment burdens this calculation assumes that a borrower's PLUS in-school interest obligations are allowed to accrue until repayment of principal begins. Borrowers are assumed to remain in school for three years and repayment is assumed to last for seven years.

5. Technically, under the 1981 legislation, lenders can now make federally guaranteed 9 percent loans to students who do not demonstrate need. But such loans would merit no special allowance payments as well as no in-school interest subsidy. Without an assurance of market yields, private lenders will not provide funds. Educational institutions, however, whose primary concern is loss from default, might be willing to make loans to their students on this basis.

The Role of the States

Cutbacks in federal support for student loans have created pressure for states to fill the void. There is irony in this new pressure. Before the federal government created GSL, more than a dozen states were in the business of guaranteeing college loans. The Massachusetts loan agency antedates the federally guaranteed effort by a decade, celebrating its 25th anniversary in 1981. New York decided to pay the interest for its in-school borrowers in 1961. The initial federal legislation for GSL was, in fact, largely modeled on the New York experience. Now with the prospect of reduced federal aid, states are once again being turned to for innovation and creativity.

One avenue for state assistance is the issuance of tax-exempt bonds to provide loan capital, possibly in conjunction with state guarantees against default or agreements to keep borrower costs below market rates. Another possible role for states is to increase the use of federal loan programs through enthusiastic promotion and supplementary subsidies.

Tax-Exempt Financing

The income from bonds issued by state and local governments is exempt from federal taxation (and generally protected against state income taxes in the state where the bond was issued). State and local governments are thus able to issue bonds at much lower interest rates than would otherwise be necessary. Because of this long-standing exemption, individual investors in high tax brackets are thereby able to enhance their after-tax incomes by investing in tax-exempt bonds.¹

Tax-exempt borrowing to finance construction or other capital-intensive projects was initially secured by the "full faith and credit" of the government unit issuing the bonds. In the past several decades, it has become much more common for a public authority to be created through legislation and for the bonds to be secured by expected revenues related to the bond's purpose. A wide range of activities from parking lots to housing projects to industrial parks is now commonly financed through public-authority bond issues. The extensive use and possible abuse of this technique has led a series of Administrations, including the current one, to look for ways to rein in this extensive form of credit activity.

Higher education has participated in the tax-exempt market in two principal ways. First, tax-exempt bonds have been used to fund the construction of dormitories, hospitals, and other buildings on campuses across the country. This is typically accomplished by the state establishing a public authority to borrow on the behalf of educational institutions. The bonds are repaid through the revenues from the facilities such as room and board fees, sometimes supplemented by government subsidies. In most cases, the educational institution must pledge a portion of its assets as collateral against possible default. Virtually every state now has this form of financing authority.

1. For example, an individual whose income is taxed at 50 percent would prefer to invest at a tax-free rate of return of 10 percent compared to being taxed on a rate of return of 15 percent.

The second type of tax-exempt financing has been in support of student loans.² Beginning in the late 1960s, state guaranty agencies have used tax-exempt bonds to finance their GSL guarantee and direct lending obligations. As state appropriations became more restrictive and as federal payments for administrative costs were unable to keep up with the growth of the state agencies, tax-exempt financing has become increasingly attractive. Indeed, some state agencies found they were able to generate surplus revenues on their direct lending activities by borrowing at tax exempt rates and lending at the market-based yield available in GSL. This profit margin (or "arbitrage") was reduced by the Education Amendments of 1980, which halved the special allowance payable on loans financed through tax-exempt borrowing. Currently it appears that about half the states use tax-exempt borrowing to finance at least some portion of their GSL activities.

Because of their past reliance on tax-exempt bonds, states have been inclined to turn toward this type of mechanism to finance new loan arrangements for college students. One great virtue of the tax-exempt route is the potential for providing loans at interest rates more favorable than those available from commercial sources. For example, in early 1982 student loans offered through tax-exempt financing could be provided at about 14 to 15 percent (including the costs of administration) whereas commercial consumer loans might charge close to 20 percent interest.

But there are reasons to be skeptical about the use of tax-exempt bonds as a widespread student loan alternative. First, the market for tax-exempt bonds is already strained and may reach saturation as more and more groups seek to use this method of financing. In the current fragile tax-exempt market, states issuing student loan bonds are now finding it difficult to sell long term (generally 15 year) obligations to investors interested in assets with much shorter maturities. Second, those who typically invest in tax-exempt bonds have high marginal tax rates, and these investors are finding such bonds less attractive because of recent changes in the federal income tax which reduced the maximum tax rate. Third, with the growing dependence on the tax-exempt market have come higher interest rates, and the difference in rates between tax-exempt and taxable bonds is not nearly as favorable as it once was. Finally, because of apparent abuse and extensive federal revenue loss, Administration officials are looking for ways to limit the use of tax-exempt bonds. Reforms will likely be focused on restricting the use of tax-exempt bonds for construction of shopping centers, industrial parks, and the like, but the whole range of tax-exempt financing procedures including student loans may be affected.

The most widely discussed state-sanctioned college loan alternative is one created by the Illinois legislature in 1981. Called the "Illinois plan," it is predicated on the use of tax-exempt bonds to finance operations but does not require any

2. In 1981, there was about \$2.5 billion of tax-exempt borrowing for higher education, with approximately equal shares for facilities and student loans.

state financial commitment. The plan creates a new state borrowing authority that will enter the tax-exempt market on behalf of specific educational institutions which, in turn, will be responsible for making and servicing the loans (although the work may be contracted to private firms). Participating educational institutions must establish reserves and pledge a portion of their assets to secure their lending against the risk of excessive default. To reduce the incidence of default, parents and students will be required to cosign the loan. In a number of states, groups representing private colleges and universities are lobbying for adoption of a loan alternative along the lines of the Illinois plan. Massachusetts, Iowa, and Rhode Island have passed similar legislation; Maryland and several other states appear ready to do so.

With specific regard to the Illinois approach, the notion of creating a new borrowing authority is troublesome. It takes time to establish a new organization and to achieve a satisfactory bond rating (which, of course, is absolutely essential). A year after passage of its enabling legislation, the Illinois authority is still not in operation. To reduce this delay, it may be possible to expand the scope of existing tax-exempt borrowing authorities to include student loans. New Hampshire appears to have taken the lead in this area by allowing its already well-established health facilities bond authority to sell tax-exempts for the purpose of making student loans. States could also allow their GSL agencies to expand into the area of nonfederal loans and to use tax-exempt bonds to finance such operations.

Because the Illinois approach entails no financial commitment on the part of the state, extensive reserve and collateral requirements are placed on educational institutions that wish to participate. Despite claims of the plan's proponents, it is doubtful whether many educational institutions will have credit that is good enough to allow them to participate. Consequently, the fear is that the new Illinois authority will be able to borrow on behalf of only a few wealthy schools while other institutions and their students could be left without an alternative loan source.

If states were willing to assume the commitment of insuring lenders against default, new nonfederal loan availability would not be limited to students attending credit-worthy institutions. States would also be more efficient guarantors than schools because of the greater enforcement and collection resources at their disposal. Moreover, provision of a state guarantee would enable institutions to use their limited funds for grants or interest subsidies to needy students.

Guarantees for default-related expenses are generally much less expensive than in-school interest and special allowance costs. Despite the well publicized default rate in the GSL program, guarantee costs run about 10 percent of total federal GSL obligations. A prefunded reserve of \$7 million (that was able to gain interest until used) would be sufficient to cover guarantee costs for \$100 million in private lending, assuming a default rate of 10 percent. A reserve of \$10 million would be enough to handle a 15-percent default rate. A state could further reduce the risk of default by allowing for repayment through its income tax system.

States may also decide to subsidize the borrowing terms under the alternatives that they authorize. Presently, proponents of an Illinois-type plan appear to

be depending on the availability of tax-exempt bonds at relatively low cost to keep the interest rates charged to students below what would be charged on a comparable consumer loan. But if the tax-exempt market dries up or if rates continue to be high, states could agree to keep the rate charged to borrowers below the cost of capital and servicing. In considering this option, states would do well to remember that interest subsidies can be very expensive if the federal experience with GLS is any guide. Such a financial commitment is probably outside the fiscal capacity of most states.

Instead of establishing their own loan programs, states can also choose to stimulate the use of federal loan programs to make loans available to students. As mentioned previously, two state agencies—in Massachusetts and New Jersey—experienced considerable success through their enthusiasm in promoting and marketing the PLUS program.

A number of states presently serve as direct lenders in the GSL program to supplement loan availability when private lending is insufficient. States could extend the concept of direct lending to PLUS thereby enhancing the future of new federal loan efforts. The potential for direct lending by states under GSL or PLUS, however, may be constrained by the future availability of funds through the tax-exempt bond market.

Some states, such as Tennessee, Washington, and North Carolina, have entered into agreements with nationwide banks to provide direct lending when lenders within the state cannot provide enough loans to meet the demand. This type of last-resort lending might be applied in other states for both GSL and PLUS. Washington State has also discovered a way to link tuition revenues with GSL availability by earmarking a portion of a recent tuition hike in public institutions for use as capital for GSL. To further this objective, the state legislature specifically authorized public institutions within the state to become direct GSL lenders.

It is also possible that states could choose to subsidize the loan terms their students face in the federal programs. For example, if graduate students lose their eligibility for GSL as the Administration proposes, then states could partially fill the breach by subsidizing a portion of the interest obligations of their students under the PLUS program. As in the case of the nonfederal alternatives, a drawback of state-provided interest subsidies is their potential for diverting funds that would otherwise be used to provide grants to low-income students or fellowships for graduate study. Also, in view of the many increasing demands for limited state funds, loan subsidies for postsecondary students are not likely to be a high priority for new funding in most states.

Helping with the Federal Programs

Options for Educational Institutions

Educational institutions are already active lenders, and have been so for a number of years. For the academic year 1981-82, schools lent about three-quarters of a billion dollars in the NDSL program with capital provided by federal appropriations, institutional matching funds, and repayments of previous loans. Using their own funds, institutions as direct lenders in the GSL program provided over one hundred million dollars. Nonfederal loan programs organized by individual institutions accounted for several hundred million dollars in loans, although no comprehensive information is available. In addition, schools "lend" more than a billion dollars in the form of deferred payment plans (often interest-free), credit-card transactions, and other procedures that stretch out tuition payments. Altogether, educational institutions provided over \$2 billion in loans in 1981-82.

With the prospect of federal student aid cutbacks, educational institutions anxious to assure loan availability for their students can expand their own lending activities instead of waiting for state action. Institutions with substantial resources of their own or with student populations less prone to default may also not wish to link up with statewide programs, which could involve greater risk. For institutions, or for individual schools within a university, there are a variety of loan initiatives to consider. The higher education community may wish to involve itself to a greater extent in the federal loan programs either by making loans directly or by providing subsidies previously paid by the federal government. Another set of possibilities is to establish or expand nonfederal loans at the institutional level.

Expanding Federal Loan Availability

Under federal program rules, an educational institution can use its own funds to be a direct lender. Institutions that choose to become direct lenders can benefit from the government's role—a guarantee against default, below-market interest rates for borrowers, and market-based yields for lenders—to provide an attractive package for their students and themselves.

Most schools have previously not sought direct-lender status under GSL because program rules require that potential borrowers first seek loans from commercial lenders. Students generally have been able to find a private lender and, as a result, less than 5 percent of GSL volume has been under a direct-lending arrangement with the educational institution. If, however, the GSL changes have the anticipated effect of reducing private-sector participation in the program, educational institutions are more likely to find their students searching for a loan window on campus.

But the initial financial commitment of direct lending is high, even for institutions with large endowments. Since repayment of principal does not begin until borrowers finish their education, a commitment of funds must be several times larger than the annual volume of lending it will support. For example, an initial investment of \$4 million might be needed to fund \$1 million in annual borrow-

ing.¹ These initial funding requirements could be substantially reduced, however, to the extent that a secondary market exists to allow educational institutions to sell or borrow against their student loan paper. (See p. 23 for a further discussion of the role of secondary markets.)

Linked with direct lending is the question of whether educational institutions are willing or able to administer and service a large volume of loans. Institutions must make a careful analysis of their internal capability to service loans and of the costs of contracting out this responsibility. The NDSL default experience and some problems with schools that acted as direct GSL lenders suggest that most institutions are not adequately prepared to shoulder the responsibility of loan servicing and collection on a large scale.

Those institutions that do not wish to or cannot act as direct lenders could encourage banks, savings and loan associations, and other private lenders to participate more fully in both the GSL and PLUS programs. Colleges and universities are generally important contributors to the local community and they should be able to wield some influence over area bankers to lend to their students. Schools need not feel ashamed in pushing the federal loan programs which, with their guarantee provisions and market rates of return, continue to be an attractive investment opportunity for most private lenders.

Educational institutions should also take the necessary steps at the state level to make sure that a PLUS program is in place and operational. Moreover, efforts could be made to introduce or expand direct lending for both GSL and PLUS by the state agencies if it appears that private lenders are not making enough loans available within the state.

Whether as direct lenders or through the use of private capital, educational institutions could subsidize GSL or PLUS borrowing by students or parents, thereby substituting their own funds for what used to be federal costs. For example, schools could pay the origination fee for GSL borrowers or subsidize the interest rate for PLUS borrowers.

Assume the Origination Fee. For GSL borrowers, the new requirement to pay an origination fee (also called a "discount" or "points") represents an additional cost of going to college. For some students, it could represent an added financial burden that tips the scales about where or whether they go to college. This burden obviously will increase if the origination fee is raised as many have proposed. Educational institutions may wish to assume the origination fee for those students who appear to be especially affected by this new cost. One argument against this particular approach is that students who are required to pay the origination fee are doing so because they remain eligible to borrow at favorable GSL terms. Con-

Reducing the Cost to Borrowers

1. This calculation assumes (1) that borrowers stay in school for an average of three years after receiving a loan, (2) that borrowers pay interest while in school, and (3) that the loan capital fund can earn interest until used for loans. Different assumptions would change the estimate of initial funding requirements for a private student loan program.

versely, to the extent that GSL borrowers must demonstrate need, perhaps paying the origination fee for these students is an appropriate role for educational institutions.

Subsidize a Portion of Interest. For schools that wish to subsidize borrowing it may be preferable to help students or their families who must borrow in PLUS at less favorable terms than GSL. Institutions could offer to pay a portion of the interest obligation for students, spouses, or parents who borrow under the PLUS option. A university could decide, for example, to guarantee their students an interest rate of 9 percent regardless of whether they were eligible to borrow under the GSL or PLUS programs. If there is concern that some students will be unable or unwilling to incur interest obligations while in school, there could be a payment of at least a portion of the in-school interest for some of those who borrow under the PLUS program. With the increase in the interest rate to 14 percent, however, the costs of this option obviously rise.

The cost of providing subsidies varies widely. Whereas a commitment now of \$50,000 pays the origination fee for \$1 million in borrowing, an upfront commitment to pay the in-school interest could require \$300,000 per \$1 million of borrowing in GSL and closer to \$500,000 for PLUS. To subsidize the interest rate paid throughout the course of the loan by, say, three percentage points, would require about \$150,000 per \$1 million borrowed. Given the substantial costs involved in subsidizing loan terms, institutions might want to target the provision of these subsidies on students or parents deemed most needy. (Appendix C presents the methodology used to estimate costs.)

Private Loan Possibilities

As previously discussed, one alternative open to educational institutions is to borrow through state authority in the tax-exempt market in order to provide loan capital at relatively low cost to borrowers. Other nonfederal possibilities include educational institutions or a consortium of schools using their own or private-sector funds to finance nonfederal loans.

Many private loan plans are already in effect around the country, principally at professional schools. Under this concept, schools could use their own funds to lend to their students who are not eligible for federal programs or for whom federal loan limits are insufficient to cover the total cost of attendance. In many instances, schools instead direct their students to a participating bank which perhaps has agreed to lend at only a modest profit above the bank's cost of money and servicing.

Schools may also decide to subsidize loan terms faced by its students or to contribute to reserves against default. As in the case of federal or state governments, the cost of subsidizing interest rates generally costs more than providing insurance against default. Schools intent on assuring loan availability could, for instance, agree to deposit funds in a bank to act as reserves against an above-average incidence of default, a risk-reducing action that could also help convince the lender to lower the interest rate it charges to student borrowers.

One obstacle to the development of private loan plans may be lender re-

luctance to make fixed-rate loans when the future course of interest rates is so uncertain. In the GSL program, the federal government fully assumes the risk of high interest rates by making quarterly payments to lenders tied to changes in the rate for 91-day Treasury bills. Many lenders claim that their GSL participation would be severely limited or nil without the variable-yield features built into the existing special allowance procedures.

Educational institutions or other organizations could spur the growth of private loan plans by covering all or part of the cost attached to higher interest rates. For example, a bank could make loans to students at current interest rates with the school agreeing to make a special payment to the lender if interest rates rise during the course of the loan. Some have suggested that one role for foundations in the area of student loans would be to assume this role of bearing the risk of high interest rates. A drawback to this arrangement, of course, is the possibly substantial liability that would be incurred; agreements would have to be drawn carefully to prevent an open-ended or excessive financial commitment on the part of the schools, foundations, or others.

Institution-based nonfederal loan arrangements have some distinct advantages. Schools do not have to pledge assets they do not have, no government red tape is involved, there is no dependence on tax-exempt financing, and institutions can tailor loan terms to meet the particular needs of their students.

A major concern about establishing private loan programs is the difficulty of creating a secondary market. Loans with different interest rates, repayment terms, and other characteristics detract from the liquidity needed to insure a functioning secondary market. The growth of this form of alternative will be limited to the extent that a secondary market does not arise to help lenders with their cash flow needs.

A number of schools have already established private programs or appear ready to move in this direction. For example, Dickinson College in Pennsylvania plans to use endowment and borrowed funds to lend to the parents of its students. Parents are expected to pay only interest while their children remain at Dickinson. The school hopes to keep interest rates several points below market levels.

Loyola University of New Orleans plans to offer 14 percent loans to students regardless of their family income. Loyola would in effect subsidize the difference between market costs of borrowing and the 14 percent charged to their students. A local bank will be responsible for making and servicing the loans.

Beloit College in Wisconsin would take the private loan concept several steps farther with what it calls "moral obligation" scholarships. Under this approach, students would be encouraged, but would not be legally obligated, to repay scholarships they received while in college. In addition to the obviously greater flexibility in repayment schedules and the absence of interest charges, moral obligation scholarships also hold the advantage that repayments could be considered charitable contributions for tax purposes. The Internal Revenue Service, however, has yet to issue an opinion on whether repayments of this kind can be classified as gifts to the college.

Other Alternatives

As has been noted, states and educational institutions have limited financial resources to meet the challenge of providing sufficient loans at affordable prices. Some other possible ways to expand loan financing include more corporate involvement, greater use of secondary markets, and further development of family savings plans perhaps in combination with additional tax incentives.

Corporate Involvement

The Reagan budget cuts have led to great pressure being exerted on corporate philanthropy. All forms of not-for-profit organizations are looking toward corporate giving to help make up for federal budget cuts. But helping finance the cost of college may merit special consideration in that postsecondary education is a major training ground for the talent needed by the corporations of America. Currently, most companies pay relatively little for this valuable resource.

Many employers already offer tuition assistance plans to their employees, but few do so in the form of loans. One obvious means for corporations to help out is to act as a lender. Such a role seems precluded in the federal programs by rules requiring that lenders be either a financial or educational institution. Corporations could contribute, however, to particular institutions for the purpose of expanding loan funds.

United Student Aid Funds (USAF), a nonprofit organization involved in all facets of student loans for over two decades, has developed corporate loan plans under GSL for over 75 companies and other organizations. Under this arrangement, the sponsor organization funds a 2-percent reserve against default and USAF then agrees to find loan funds for the sponsor's employees or their families. This structure should be readily adaptable for PLUS loans to employees to help with financing their children's education.

Another possibility would be for companies to encourage local banks to become PLUS lenders for their employees, an arrangement that would involve no financial commitment on the part of the employers. In addition, PLUS borrowing by employees could be subsidized as part of a company's benefit package. For example, a portion of the interest rate might be paid by the employer, either just for the in-school period or perhaps throughout repayment as long as the parent remains an employee of the company.

Companies might also elect to establish nonfederal loan programs to help employees cover the costs of college for themselves or for their family members. Such a program might be financed with internal corporate funds, through borrowing, or in direct cooperation with a local banking establishment. As with the federal programs, loan terms could be subsidized as part of the company's employee benefit package.

Corporate support for college loans can also be made in a way that acknowledges more directly that postsecondary education is a prime provider of employees for corporate America. Companies could agree to pay a portion of loan repayment obligations for borrowers who become employees. Beloit College in Wisconsin advocates what it calls a "cancellable loan," an arrangement in which a

company would agree to pay a portion of the loan repayment obligations for individuals it hires.

Secondary markets are a common and important feature of many lending and borrowing transactions. They allow financial institutions to trade assets to meet their liquidity and investment needs. One of the most common uses of secondary markets has been in the housing industry because of the long-term nature of mortgages.

The Student Loan Marketing Association, commonly called Sallie Mae, was created in the Education Amendments of 1972 to serve as a much needed secondary market for student loans. Lenders were anxious to have a place where they could exchange their student loan holdings for cash as their financial conditions and needs changed over time. Sallie Mae, a government-created private corporation, is intended to fulfill this purpose by either buying or lending against student loan paper.

Sallie Mae's growth in the past several years has been exceptional. It now holds assets of over \$5 billion, a growth aided by its past authority to borrow under Treasury auspices at favorable rates. But because of changes brought about in 1981, Sallie Mae now must borrow new funds without federal advantage and its ability to offer favorable terms to lenders will probably be impaired.

The 1980 and 1981 legislation also greatly expanded Sallie Mae's potential role in college loans. Under these amendments Sallie Mae is responsible for developing a loan consolidation plan so that students with federal loans which carry different rates and terms can package their obligations into a new loan with one repayment schedule. If the Secretary of Education determines that federal loan availability is insufficient in a particular state, Sallie Mae can provide funds directly and thereby act as a lender of last resort. Moreover, the recent legislation broadly extends Sallie Mae's charter to cover any activity related to borrowing for college, including loans which are not federally supported. The degree to which Sallie Mae can raise new capital once it finds itself outside the federal borrowing umbrella will in large measure determine its capacity to move into these new areas.

Thus far, Sallie Mae has been the most visible secondary market for student loans. But in the past year or so, a number of states or lending institutions have decided to establish small secondary market operations, and this new competition to Sallie Mae will likely change substantially the nature of the secondary market for student loans.

The existence of a secondary market has been critical in the recent growth of GSL. Efforts should be made to encourage new sources of funding for secondary markets in student loans. For example, many pension funds could increase their yield by investing through a secondary market in variable-rate student loans while not increasing the risk of their asset portfolios since these loans carry a government guarantee. Or foundations could provide short-term capital to bridge the fi-

Secondary Markets

nancing gap that may exist for cash-poor school lenders until borrowers leave school and repayment of principal begins.

Savings Plans and Tax Incentives

One alternative to loans for meeting college costs is for families to establish savings plans before their children enter postsecondary education. Some incentive exists under current tax laws for families to save for college, flowing from the fact that children generally face lower tax rates than their parents. One means for capturing this tax advantage is to set up custodial accounts in the child's name. Another possibility is for parents to borrow and deduct the interest from their taxable income, while the children in their own name invest the loan proceeds and pay a smaller tax. A number of avenues exist for moving in this direction, including Clifford trusts and so-called Crown loans. Some have been the subject of heated court cases, and the verdict is still out as to their legality. Generally, only higher-income families can benefit from these tax-related advantages.

If the government wishes to encourage savings plans for college, additional steps could be taken to increase the tax advantages for parents from a wide range of incomes. New York State, for example, allows its residents to deduct up to \$1,000 each year from their state taxable income for the purpose of saving for educational expenses. The Citizens League of Baltimore, among others, has proposed that federal legislation be enacted to expand the notion of tax deductible saving for retirement to allow similar federal tax deductions for education-related saving. The "Baltimore plan" also calls for a portion of the savings to be diverted to a fund for grants to needy students, thereby insuring that tax-related benefits accrue to students at the lower end of the economic scale, not just those who are in a position to take advantage of tax breaks.

Tax-sheltered savings plans for education could well surface as an alternative to proposed tax credits for current educational expenses. For any given revenue loss, tax benefits related to savings can cover a much larger share of college costs than the conventional tax credit approach. In addition, a plan to provide tax advantages for saving can be structured to help a broader range of social groups than can tax credits, especially if a component of the savings is devoted to grants for needy students such as proposed in the "Baltimore plan."

Savings plans can also be linked to loans for college regardless of tax advantage. For example, an Atlanta firm, Student Financial Services, has promoted a "tuition reserve and deposit plan" in which funds deposited in a savings account serve as collateral for college loans. This "passbook loan" concept, already used for many kinds of consumer lending, may have a great deal of potential for student loans as well. The advantage in this approach is that the loan amount can be several times larger than the funds deposited in the savings account (as the savings serve as partial collateral against default). In addition, interest rates can be kept below market levels since part of the loan is in effect being financed by relatively low-cost savings deposits.

Appendix A:

Aid Available to Students Through Federal and State Programs

Changes in federal student aid programs proposed by the Reagan Administration in 1982, if fully adopted, could severely curtail assistance available to students to finance their college costs. The table below provides estimates of the grants, loans, and work-study funds available in selected years. The figures include federal funds for all programs except GSL, GSL and PLUS loan volume, institutional matching funds in work-study and NDSL, new loans made from NDSL revolving funds, and state funds for grant and scholarship assistance.

All figures for fiscal 1984 are Administration estimates except for GSL and PLUS loan volume, which is based on Congressional Budget Office projections of the Administration's proposals.

Taken together, the amount of assistance available through federal and state programs would fall by \$7 billion, a drop of over 40 percent, between fiscal years 1981 and 1984. Under the Reagan plan, aid available in 1984 would be approximately the same as what was provided in 1978 before passage of the Middle Income Student Assistance Act.

Student Aid Available Under Federal and State Programs
(in billions of dollars)

	FY 1978	FY 1981	Reagan Proposals FY 1984
Loans (GSL and NDSL Volume)	\$ 2.7	\$ 8.5	\$ 5.9
Grants and Work	3.1	4.4	2.7
Social Security and Veterans Benefits	<u>4.2</u>	<u>3.9</u>	<u>1.3</u>
TOTAL	\$10.0	\$16.8	\$ 9.9

This table is adapted from the April 1982 report of the Washington Office of The College Board entitled "The Federal Budget and the Outlook for Students in Higher Education."

Appendix B:

Legislative Chronology of Federal Student Loan Programs

- 1958** • National Defense Student Loan (NDSL) program created to allow educational institutions to lend at 3 percent interest to needy students. Ninety percent of loan capital to be provided through federal appropriations with schools matching the remaining 10 percent. Loan repayments to institutions to be used for new loans.
- 1965** • Guaranteed Student Loan (GSL) program authorized as part of the Higher Education Act. Private sector loans at 6 percent interest with state guarantee against default-related losses. Federal insurance is made available for loans where a state guarantee is not forthcoming. For students with family income below \$15,000, federal government agrees to pay in-school interest obligations and one-half of the borrower's interest during the repayment period.
- 1968** • GSL interest rate raised from 6 to 7 percent. The federal government clarifies its agreement to reinsure state guaranty agencies for 80 percent of their default-related losses. Also, the provision of partial federal payments of interest during the repayment period is dropped.
- 1969** • Federal government agrees to pay GSL lenders a special allowance (up to 3 percent of outstanding loan volume) so that GSL rate of return can remain competitive with rising market interest rates. Committee of government officials to meet every three months to set special allowance rate.
- 1972** • Student Loan Marketing Association (Sallie Mae), a private corporation, is authorized for the purpose of creating a secondary market for student loans.
- For GSL loans made after July 1, 1972, students would have to demonstrate financial need to qualify for federal in-school interest payments. Because of confusion and resistance resulting from this requirement, the Congress in August postpones implementation of provision.
- Name of NDSL changed to National *Direct* (instead of Defense) Student Loans.
- 1973** • Needs test requirement for GSL dropped. Instead, students with family income above \$15,000 can qualify for in-school interest subsidy if they can demonstrate extreme financial need.
- 1976** • Family income ceiling to qualify for federal in-school interest payments raised from \$15,000 to \$25,000.
- Greater incentives for states to expand or initiate guaranty agencies are provided, including: 100 percent federal reinsurance for states with lower default rates; administrative allowance to state agencies (not to exceed 1 percent of new loan volume); allowing state agencies to retain up to 30 percent of their collections on defaulted loans to cover administrative costs.

- Steps taken to reduce GSL default rate, including: restrictions on lending by educational institutions; stricter requirements on lenders and borrowers in disbursement and due diligence procedures; and new rules to prevent GSL borrowers from declaring bankruptcy to avoid their loan repayment obligations.

- Special allowance repayments tied directly by formula to quarterly changes in the 91-day Treasury bill rate. Cap on special allowance payments raised from 3 to 5 percent of outstanding loan volume.

1977

- Income ceiling of \$25,000 removed entirely; students from all income levels may qualify for in-school interest subsidy.

1978

- Cap on special allowance is eliminated so that quarterly payments to lenders may keep up with escalating interest rate conditions.

1979

- GSL interest rate for new borrowers (after January 1, 1981) raised from 7 to 9 percent.

1980

- Responsibilities of Sallie Mae are extended to include: development of a loan consolidation program to allow students to repackage their loan repayment obligations for loans of varying terms and length; advances to state agencies that wish to act as lenders of last resort; more flexibility in arrangements for "warehousing." In addition, Sallie Mae's ability to borrow under federal auspices is extended through fiscal year 1984.

- A new program—Parent Loans for Undergraduate Students (PLUS)—is authorized to allow parents to borrow. Interest rate for PLUS loans set at 9 percent—the same as GSL—but repayment of interest and principal to begin within 60 days of when loan is made.

- NDSL interest rate raised from 3 to 4 percent.

- A five percent origination fee charged on GSL borrowing after August 1981 to be deducted from the face value of new loans. Revenues from the fee will offset payments the federal government would otherwise make to lenders, thereby reducing annual federal costs for GSL.

1981

- To qualify for GSL, students with family income above \$30,000 must demonstrate financial need. Put another way, parents with income above \$30,000 will not be able to substitute a GSL for what they are expected to contribute to their children's education.

- Interest rate on PLUS loans raised from 9 to 14 percent. In addition, eligibility for PLUS is extended to graduate and professional students and undergraduates financially independent of their parents.

- Sallie Mae's list of responsibilities is further extended to cover any issue relevant to student borrowing including, for the first time, loans not insured by the federal government. In addition, an agreement is reached that Sallie Mae will lose its ability to borrow as a federal entity beginning October 1, 1982.
- NDSL interest rate raised from 4 to 5 percent.

Appendix C:

The Cost of Loan Subsidies and Guarantees

States, educational institutions, corporations, or other organizations may decide that to maintain the availability of college loans or to make loan terms affordable to students and their families, it is desirable to subsidize loan terms or conditions. These loan subsidies may take the form of keeping interest rates charged to borrowers below market rates or providing financial assurances to lenders against possible default risks.

The cost of providing these subsidies depends on a number of factors that are difficult to predict, including the future of interest rates, the length of time students remain in school, the number of years loans are in repayment, and the default rate.

The federal government has discovered through its experience with GSL just how difficult it is to gauge the future cost of student loan programs. What started out as a relatively low-cost program in the 1960s has turned into a \$3-billion behemoth in the 1980s. A portion of these costs, of course, can rightly be attributed to deliberate legislative decisions to maintain GSL availability or to expand the range of students eligible for federal subsidy. But federal costs for GSL have also grown because of totally unpredictable interest rates and unplanned (and embarrassing) default rates.

Whenever program costs extend far into the future, as is the case with student loans, the margin of error is much larger than when only one or two years of estimates are involved. There is also the temptation to underestimate the magnitude of future costs in the hope of selling the program today.

Responsible organizations, before deciding to subsidize the terms of student loans, must first attempt to estimate the costs involved. Their task is complicated by the unpredictability of many of the factors that should be taken into account.

The following tables are provided to indicate the costs of interest subsidies and loan guarantees based on several different sets of assumptions. There are, of course, innumerable possibilities regarding future interest rates, subsidy levels, default rates, and the like. The estimates provided here are intended to portray the relative magnitude of costs for a selected range of assumptions.

Costs in these tables are displayed on a present-value basis per \$1,000 in borrowing; that is, cost estimates reflect the fact that inflation and interest rates make future dollars less valuable than current dollars. Calculation of present values is an analytical technique which responds to the question: how much is needed today to assure that "x" amount will be available in the future, assuming that funds, until expended, are able to accumulate interest at an estimated rate (called the discount rate). For the tables in this Appendix, present values using two different discount rates are displayed: 10 percent and 15 percent. Costs are also shown for a discount rate of 0, i.e., in nominal dollar terms not reduced for the future cost of money.

The costs of paying the interest obligations for borrowers while they remain in school are obviously very dependent on the length of time borrowers are in school and the interest rate that is charged. The estimates in the following table

In-School Interest

assume that borrowers remain in school for a period of 3 or 5 years after the loan is made. These calculations also assume that an interest rate of 10 percent is charged, payable at the end of each year.

**Present Value of In-School Interest Payments
on 10 Percent Loans per \$1,000 Borrowed**

Discount Rate	Years In-School	
	3 Years	5 Years
0% (nominal dollars)	\$300	\$500
10%	\$249	\$379
15%	\$229	\$340

Interest Subsidies

Another means for making loan terms more attractive to borrowers is to subsidize the interest rate they pay over the course of the loan. The tables below indicate the costs of subsidizing interest rates by 3 percentage points under two sets of assumptions: 3 years in school and 7 years in repayment, or 5 years in school and 10 years in repayment.

**Present Value of Interest Rates Subsidized
by 3 Percentage Points per \$1,000 Borrowed**

Discount Rate	3 Years In School, 7 Years Repayment	5 Years In School, 10 Years Repayment
0% (nominal dollars)	\$195	\$295
10%	\$135	\$178
15%	\$118	\$147

Reserves Against Default

The federal government encourages use of GSL by insuring lenders against default-related risks. This guarantee function could also be accomplished through reserve deposits placed with the lender which would be drawn down as defaults occur. The following table indicates how much would have to be deposited when a loan is made to provide for default rates of 5, 10, and 15 percent. For purposes of the calculations shown below, defaults are assumed to occur 3 years after the loan is made (the average length of time that GSL borrowers remain in-school after the loan is made).

**Present Value of Reserves Against Default
per \$1,000 Borrowed**

Discount Rate	Default Rate		
	5%	10%	15%
0% (nominal dollars)	\$50	\$100	\$150
10%	\$38	\$ 75	\$113
15%	\$33	\$ 66	\$ 99